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## Table of Contents

# INVESTIGATING AND PROSECUTING MARKET MANIPULATION


Technical Committee
of the
International Organization of Securities Commissions

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# INVESTIGATING AND PROSECUTING MARKET MANIPULATION[1]

## INTRODUCTION

Public confidence in the fairness of markets enhances their liquidity and efficiency. Market manipulation harms the integrity of, and thereby undermines public confidence in, securities and derivatives markets by distorting prices, harming the hedging functions of these markets, and creating an artificial appearance of market activity. Accordingly, authorities around the world need to have adequate systems in place to detect, investigate and prosecute market manipulation[2].

While the character and harmful market effects of market manipulation are well known, the incentives, means and opportunities for carrying out manipulative schemes continue to evolve. As new products and new technologies are developed, as new market participants undertake trading activity, and as trading on global and interconnected markets continues to grow, the risk of cross-border and cross-market manipulation increases.

Furthermore, with the growth of derivative products, there may be an increased incentive to manipulate the asset underlying the contract. For example, the price of securities can be manipulated to affect the price of a derivative contract or other products (e.g., convertible preferred shares) that are tied in some form to those securities. When such distortions occur, innocent counterparties and market participants who engage in transactions at those manipulated prices can be harmed, including public companies, pension funds, collective investment vehicles, banks, and governmental bodies.

The Internet also has increased the opportunities for manipulating the market for securities. With its development as a popular tool for exchanging information about securities, the Internet has become an easy and inexpensive method to disseminate information to vast numbers of people instantaneously. The Internet thus also provides an unparalleled opportunity to disseminate information about a

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1 This report undertakes to provide information on manipulation that takes into account enforcement issues raised by cross-border and cross-market conduct. Work on this report was undertaken following substantial work in this area at the Tokyo Conference of Commodity Futures Market Regulators which issued guidance on Standards of Best Practice for the Design and/or Review of Commodity Contracts and on Components of Market Surveillance and Information Sharing. *See also* the Report of the IOSCO Technical Committee on the Application of the Tokyo Communiqué to Exchange Traded Financial Derivatives Contracts, dated September 1998.

2 This report is intended to be descriptive in nature and is not intended to prescribe the specific contours of manipulative conduct that are or should be prohibited in the jurisdictions of the members of the Technical Committee Working Group on Enforcement and the Exchange of Information (TCWG-4). It should be noted that this report does not address legally permissible practices, which may have an effect on market prices. For example, price stabilization efforts are permitted in some jurisdictions.

particular security with the intention of moving its price or even creating the appearance of an active market in a security.

The existence of global and interconnected markets increases the opportunities for market manipulation, as well as the difficulty in detecting and investigating manipulation. The securities, derivatives and the underlying assets whose prices are manipulated may be traded on one market or in one jurisdiction while the persons responsible for the manipulation may be located elsewhere. Indeed, the price of securities or derivatives may be manipulated in one market for the express purpose of affecting their price, or the price of underlying assets, in another jurisdiction or market. Where, for example, derivatives traded in one country are based on an underlying foreign securities index, there may be a motive to manipulate the market for the securities comprising the index. As a result, regulators of both markets can be faced with the challenge of obtaining information regarding trading and positions located in the other jurisdiction. In addition, regulators and authorities may need access to information relating to foreign bank accounts. In certain circumstances, the use of foreign nominee corporations complicates the collection of information and the detection of the illegal activity.

It should be noted that, in some jurisdictions, regulators do not have direct powers to investigate market manipulation. Nevertheless, even if not vested with these powers, regulators need to be cognizant of the manipulative conduct that is prohibited in foreign markets, particularly in an era of global markets. Regulators should also be aware of the wide range of methods used for detecting market manipulation. While the specific elements of investigating and proving manipulation may differ in various legal and regulatory systems, regulators of international markets should have a common understanding of the types of information that can be useful in such proceedings. Moreover, regulators should understand the challenges that exist in taking enforcement action against market manipulation. This Report seeks to assist regulators in their efforts to ensure that they have effective systems in place to address manipulative activity.

Finally, regulators need more than ever to work together and with others to prevent market manipulation where possible and to cooperate in its detection, investigation and prosecution. Regulators must often seek assistance both domestically and internationally to obtain relevant information regarding manipulative activities. Therefore, they need to be able to be assured of the assistance of other authorities. Regulators should work in partnership with their domestic exchanges to the extent possible. Where necessary, they should promote and facilitate cooperation between exchanges. In addition, regulators should be able to obtain assistance from their foreign counterparts, either through Memoranda of Understanding, or other formal or informal arrangements. Where appropriate, regulators may also need to obtain cooperation from other authorities who have access to and the ability to share information useful to investigating and proving market manipulation.

Drawing on the practical experiences of the members of the Technical Committee Working Group on Enforcement and the exchange of Information (TCWG-4), this report:

- sets forth the nature of the manipulation violation in the jurisdictions of TCWG-4 members ;

- identifies measures that can be useful and effective in the detection, investigation and prosecution of manipulative activity ;

- explores the role of exchange-to-exchange cooperation (when permitted by law) in detecting and investigating potential manipulations and ascertains the specific vehicles available for cooperation and information sharing between exchanges and between exchanges and regulators ;

- takes note of the circumstances where international cooperation in the investigation and prosecution of manipulative activity may be needed ; and

- recommends that securities and derivatives regulators charged with enforcing laws, regulations and rules that prohibit manipulative conduct should have :

  - effective tools to prevent and detect market manipulation, including laws that proscribe manipulation with sufficient clarity and flexibility to allow prosecution of novel manipulative schemes ;

  - adequate authority to investigate, prosecute, and deter market manipulation and/or the ability to work with other domestic authorities that investigate, prosecute and deter market manipulation ; and

  - the ability to cooperate at all stages of a matter -- from surveillance, through investigation, to commencement of an action -- across markets and across borders.

This report recognizes that the possibility of manipulation is, in part, a function of the characteristics (e.g. size and liquidity) of the market and, in the case of derivatives, the underlying cash market as well. Jurisdictions have different approaches to defining, detecting, investigating and prosecuting market manipulation and this report is not intended to recommend one specific approach over another. Rather, it can serve as a practical resource concerning the various regulatory approaches taken with regard to manipulation. The drafters are aware that confidence in the fairness of markets enhances their liquidity and efficiency, and that regulation should seek to bolster such confidence by effectively detecting, investigating and prosecuting manipulation. However, the working

party also recognizes that regulation should not unduly restrict the freedom to trade.

## II. TYPES OF MANIPULATIVE CONDUCT

The elements that comprise manipulative conduct tend to vary depending on the type of market[3]. The sanctions applicable for violations of laws and rules prohibiting market manipulation also vary from jurisdiction to jurisdiction. In some jurisdictions, manipulative conduct is a criminal offense and can result in criminal liability only. In other jurisdictions, manipulative conduct can lead to civil/administrative liability or both criminal and civil/administrative liability. Moreover, in some jurisdictions, manipulation of the securities market is addressed differently from manipulation of the derivatives market. It is also the case that some authorities choose not to define specific violative conduct in a statute or rule; rather, they define the contours of the illegal conduct through case law or other precedent. What follows below is a discussion of some of the elements that comprise the manipulation offense as well as some examples of manipulative conduct.

Types of manipulative conduct may be categorized according to the methods used, the objectives of the underlying activity, and the parties involved [4].

### A. Methods

A number of the methods used include:

- Engaging in a series of transactions that are reported on a public display facility to give the impression of activity or price movement in a security (*painting the tape)*[5] *;*

- Improper transactions in which there is no genuine change in actual ownership of the security or derivative contract *(wash sales) ;*

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[3] Members of TCWG-4 submitted short papers describing the manipulation laws in their jurisdictions. These submissions helped to identify the authorities within each jurisdiction with responsibility for addressing such offenses and the scope and source of their enforcement powers. A summary of these submissions is contained in Annex 1. Certain members of the Emerging Markets Committee Working Group on Enforcement and Exchange of Information (EMCWG-4) also provided information on the manipulation laws in their jurisdictions. A summary of these submissions is contained in Annex 3.

[4] Examples of certain types of manipulative conduct have been provided by members of TCWG-4, based on manipulation cases from their respective jurisdictions. Most of the examples involve transactions or other activities carried out in more than one market. These examples are described in Annex 2 to this report.

[5] Wash sales and improper matched orders are often used in manipulations involving painting the tape.

- Transactions where both buy and sell orders are entered at the same time, with the same price and quantity by different but colluding parties (*improper matched orders*) ;

- Increasing the bid for a security or derivative to increase its price *(advancing the bid*) ;

- Buying activity at increasingly higher prices. Securities are sold in the market (often to retail customers) at the higher prices (*pumping and dumping)* ;

- Buying or selling securities or derivatives contracts at the close of the market in an effort to alter the closing price of the security or derivatives contract *(marking the close)* ;

- Securing such control of the bid or demand-side of both the derivative and the underlying asset that leads to a dominant position. This position can be exploited to manipulate the price of the derivative and/or the asset (*corner*). As regards derivatives, in a corner, a market participant or group of participants accumulates a controlling position in an asset in the cash, derivative and other markets. The market participant or group of participants then requires those holding short positions to settle their obligations under the terms of their contracts, either by making delivery or by purchasing the asset from the manipulator or by offsetting in the derivatives market opposite the manipulator at prices distorted by the manipulator *;*

- Taking advantage of a shortage in an asset by controlling the demand-side and exploiting market congestion during such shortages in such a way as to create artificial prices *(squeeze)* ; and

- Dissemination of false or misleading market information through media, including the Internet, or by any other means. The dissemination is done in order to move the price of a security, a derivative contract or the underlying asset in a direction that is favorable to the position held or a transaction planned by the person disseminating the information[6].

### *B. Objectives*

The objective of manipulative conduct will normally be to make money either directly through transactions, or by other means. Some examples of how this motive is achieved include:

[6] In some jurisdictions, dissemination of false or misleading information constitutes a separate offense prosecuted under laws not specifically directed at manipulation.

- Influencing the price or value of a security or a derivative contract, so that the manipulator can :

  - buy at a lower price,
  - sell at a higher price,
  - influence takeover bids, or other large transactions, or
  - combat competitive transactions ;

- Influencing the price of a derivative contract or the underlying asset ;

- Influencing the price of a security underlying an index ;

- Influencing the subscription price in public or non-public offerings ;

- Influencing the price/conversion ratio in connection with merger of companies ;

- Influencing the price of a security in connection with take-over offers ;

- Influencing someone to subscribe for, purchase, or sell assets or rights to assets, or to abstain from doing so ;

- Influencing the accounts/balance sheet of institutional investors ;

- Influencing the limit for triggering forced sale by creditors ; and

- Influencing the impression of financial advice or placements.

### *C. Parties involved*

Those in a position to effect a manipulation include:

- Issuers of securities ;

- Participants in the securities market, derivatives market or underlying cash market ;

- Market intermediaries ; and

- Any combination of the above acting in cooperation with one another.

It is important to note that the methods used in many manipulation cases involve transactions or other activities carried out in two or more affected markets. These markets may be within the same or different jurisdiction. Manipulation involving cross-border activities often involves parties (physical and/or legal persons) that are domiciled in different jurisdictions.

# III. TOOLS FOR PREVENTING MARKET MANIPULATION

There is a wide range of tools that are used to prevent and deter manipulative conduct in both securities and derivatives markets. Anti-manipulation regulation focuses on maintaining the integrity of the market price of securities, of derivatives contracts and of the assets underlying such contracts. The rules attempt to ensure that a price is set by the unimpeded collective judgement of buyers and sellers. In addition, the rules attempt to prevent introduction of misinformation into the market and abuse of market power. Such rules enhance a regulator's ability to secure the independent trading and pricing mechanism of the marketplace[7].

In some jurisdictions, manipulation may be prosecuted under rules that govern fraudulent activity. As an example, one jurisdiction can prosecute as a fraud, a transaction in a security that either creates actual or apparent trading in such security or causes a rise or decline in the price of such security, and that is intended to defraud or that operates as a fraud or deceit, upon the market for the security.

Rules imposing disclosure requirements should be considered as an additional tool for preventing manipulation. For example, requesting the issuer of listed securities to disclose timely price sensitive information is aimed, among other things, at reducing information asymmetries that can facilitate manipulation. The timely dissemination of trading data (both pre and post-trade) is also crucial to reduce information asymmetries among market participants.

Some jurisdictions may also have rules that prohibit manipulation in specific situations. For example, such rules can prohibit manipulative activities on particular markets. In addition, a jurisdiction can have rules that prohibit manipulation by particular market participants. Some rules require a showing of manipulative intent or purpose. In addition to the broad prohibitions at the core of anti-manipulation rules, there are a number of other provisions and tools designed to prevent manipulation. Some are discussed below.

## *A. Securities Markets*

### 1. Short selling rules

In certain jurisdictions, a short sale is defined as the sale of a security that the seller does not own or that the seller owns but does not deliver to the purchaser. In order to deliver the security to the purchaser, the short seller will borrow the

[7] Disclosure and transparency requirements focus on generating and maintaining integrity of the price formation process, and manipulation prohibitions focus on preventing harm to that integrity.

security, typically from a broker or an institutional investor. The short seller later closes out the position by returning the security to the lender, usually by making a purchase on the open market. Purchases on margin also may be used by manipulators to accelerate a market trend.

In some jurisdictions, short selling rules prevent sellers from engaging in activities that cause or accelerate declines in securities prices, irrespective of the intention of the short seller. In addition, rules requiring the disclosure of short sales (either to the regulator or the market or both) are used by many jurisdictions to deter or prevent manipulative short selling.

## 2. Rules limiting participation during offerings

Securities offerings present special opportunities and incentives for market manipulation. Around the time of an offering, manipulative activities can be used to increase offering proceeds by increasing the market price on which the offering will be priced, or stabilizing the market price to avoid a failed offering. Because price integrity is essential during an offering, some jurisdictions have adopted rules to prevent interested parties from creating artificial prices.

Rules limiting market activity during offerings are designed to protect the integrity of the securities trading market as an independent pricing mechanism. The rules focus on potentially manipulative activities by those likely to profit from the offering, such as by governing the activities of underwriters, issuers, selling security holders, and others participating in an offering of securities. Rather than addressing manipulation after the fact, such rules seek to prevent it. Therefore, these rules do not require proof that distribution participants have manipulative intent or purpose.

## 3. Methods for calculation of index

There are several methods for calculation of an index, including : capitalization-weighting calculation, modified capitalization-weighting, equal-currency-weighting, and modified equal-currency-weighting. In some jurisdictions, the component weightings are reviewed on a quarterly basis and are adjusted if necessary. In addition, intra-quarterly adjustments are made, as necessary, to reflect corporate actions, share issuances and repurchases, and other events of significance. Terms of any weighting calculation methodology must be clearly defined and widely published and consist of objective standards for initial and continued listing. The various methods exist essentially to ensure that the index is sufficiently balanced and diverse to make attempts to manipulate it more difficult.

In addition, requirements relating to the timing of the calculation and announcement of the level of the index can reduce the possibility for manipulation. Without such requirements, the reshuffling of a stock index, for example, can create an opportunity for manipulation.

To ensure that the trading markets for component securities are adequately capitalized and sufficiently liquid, jurisdictions may impose requirements including, minimum capitalization, monthly trading volume, averaging closing prices by volume and relative weightings of component securities. These requirements are designed to minimize the potential for manipulation of the index.

## B. Derivatives Markets

### 1. Contract design

Derivative contracts operate more efficiently and are less susceptible to manipulation, and less likely to disrupt the operation of cash markets, when the terms of the derivative contract accurately reflect the needs of the particular market in the underlying asset. Designing a derivatives contract to conform to the underlying cash market of the asset requires a detailed understanding of the characteristics and operational features of the relevant cash market. Knowledge of the cash market for an asset is critical in assessing the specifications of a derivative contract based upon that asset. Particular attention should be given to the cash pricing and delivery systems as well as historical patterns of production, consumption and supply of the underlying asset.

In the interest of ensuring proper contract design, some jurisdictions have laws and/or rules requiring that exchanges provide rules for delivery at points, grades and locational price-differentials that will tend to prevent or diminish market manipulation, market congestion or the abnormal movement of the asset in commerce. If the rules of an exchange do not fulfil these purposes, the regulator may have the power to require that the rules be changed.

With respect to option contracts, most have standardized terms, such as the nature and amount of the underlying asset, the expiration date, the exercise price, position limits, whether the option is a call or a put, and whether the option is a physical delivery option or a cash settled option.

### 2. Position limits

In order to enhance market integrity, the design elements may be accompanied by other structural measures related to the trading of the derivatives contract that can facilitate the deterrence of market manipulation. One such measure adopted in some jurisdictions is restriction on the size of positions that can be held by market participants. Position accountability and position limits are intended to inhibit the development of extraordinarily large exposures in relation to long or short positions controlled on the market and/or in relation to the financial exposure of the member to the exchange as a result of customer or proprietary positions.

Spot month position limits might be designed to prevent market participants from attempting to manipulate the price of an asset by, for example, demanding delivery of more of the underlying asset than is economically available. If imposed, exemptions from or adjustments to position limits may be granted for *bona fide* hedging purposes at levels that do not threaten the orderly liquidation of the expiring contract. Limits concerning the size of a position for one asset for future delivery (or an option thereon) that a single market participant may hold in a single contract month, or in all future months combined, can be established by either the regulatory authority or exchange. To be effective, such limits should be applied to individual market participants and to groups of participants trading pursuant to an express or implied agreement or understanding. It should be noted that concerns regarding the possibility of manipulation will not be the same for all assets. Where, for example, a particular market is exceptionally deep and liquid, position limits may not be as important.

## IV. TOOLS FOR DETECTING MARKET MANIPULATION

### A. Market Surveillance

The goal of surveillance is to spot adverse situations in the markets and to pursue appropriate preventive actions to avoid disruption to the markets. At a minimum, regulators should have access to current events in the markets. Types of surveillance methods include:

#### 1. Filing of ownership and control of companies

Rules requiring the filing of documentation of corporate ownership and control assist regulators to determine some of those likely to be in a position to effect a market manipulation or who likely stand to gain significantly from a manipulation. In addition, the ability of regulators to obtain ownership information can be useful.

#### 2. Surveillance systems

Surveillance programs include a reporting system to permit market authorities to assess large positions in light of other market factors, including deliverable supplies in the cash market, market participants' positions in other markets, concentration of positions and ability to make or take delivery, and financial exposures. Reporting systems capture the daily positions and identities of market participants whenever their open positions in a particular derivative exceed a minimum threshold level and permit market authorities to aggregate positions of related persons to facilitate identification of market power.

Surveillance systems, including information obtained through position reporting, could be designed to capture information that allows the following types of analysis:

a. tracking of changes in price or volume of a particular security or derivatives contract and underlying asset as well as changes in price or volume of related securities or derivatives contracts and underlying asset ;

b. identifying concentration of ownership and potential collusive or concerted activity by market participants ; and

c. conducting financial surveillance to identify potentially large market losses or gains incurred by firms trading for their own accounts, or by large market participants who trade through the firm.

Surveillance systems should be designed to keep pace with technological and market evolution. Exchanges can play an important surveillance role.

### B. Internet and Other Media Surveillance

Surveillance of information provided to the public should include media (newspapers, television, newsletters and analysts' research reports, etc.)[8]. In addition, on the securities side in particular, the Internet may require specific attention and surveillance skills because of its characteristics, including its ability to reach vast numbers of people instantaneously. The speed with which information disseminated over the Internet can be changed creates challenges for regulators in identifying and preserving evidence.

## V. INVESTIGATING MARKET MANIPULATION

### *A. Proving Market Manipulation*

Given the difference in the nature of securities and derivatives markets, proving a manipulation involving these markets may require different types of evidence and analysis. Separately, the laws in different jurisdictions may be distinct as to the elements that comprise the manipulation violation, and issues of proof will vary accordingly. Additionally, exchanges have responsibilities to maintain orderly markets and prevent manipulation with anti-manipulation rules and in some jurisdictions may have the power to investigate and discipline members who violate these rules. The discussion in this section is not intended to catalogue the common elements of market manipulation in *all* jurisdictions. Rather, it is intended to serve as a discussion of certain elements that TCWG-4 members have identified as necessary to prove manipulation in their jurisdictions.

[8] Such information can include both the touting of stock that can have an upward effect on the price of a particular security, or the spreading of false information that can affect the price of a security.

## 1. Investigating an artificial price or price effect

### a. Securities

If a security appears to increase suddenly in price or volume of trading, or both, such that manipulative activity is suspected, the investigator should perform some analysis of the market for the security and why the price or volume, or both, may be changing suddenly. The investigator should examine how the securities were introduced and traded in the market. If the security was previously issued and outstanding, as opposed to being a new issue, the investigation may include an analysis of the security's historical price movements.

In examining the price, one question is what the price was when it was at its highest, and whether there is an explanation for that price. If the price collapsed the question is whether it collapsed after insiders sold their securities or as a result of downward manipulative activity. The investigator should review all the publicly available information concerning the security. In addition, the investigator may be able to obtain useful information on the patterns of trading by examining the performance of peer group securities, or the securities of similar companies during the relevant period. The investigation should also consider the condition of the market as a whole -- whether it was a bear, bull, or flat market -- and how the security in question performed as compared to the overall market. Also, for the security in question, it is relevant to determine whether, prior to the manipulation period, the security was thinly traded or even inactive, and how volatile it was. The key question is whether there appears to be any logical trading pattern to the security's price and volume, or whether it seems erratic. If it is erratic, the question is whether the pattern coincides with the activities of the promoter, broker, or other participants in the potential manipulation.

The investigation of potential manipulation should focus on what information was made publicly available during the relevant period. An analysis of such information will indicate whether there is a legitimate basis for the price of the security, or of the asset underlying a derivative contract to have risen, such as favorable financial news or other newsworthy events concerning a company or market. If there is an absence of such information, and the price nevertheless rose significantly, that fact may be indicative of manipulative conduct. If there is no apparent basis for the price increase in the publicly filed or published information, the investigator should determine whether the public information is false or misleading.

### b. Derivatives

Price artificiality is the divergence of price from the legitimate forces of supply and demand. In order to establish price artificiality, it is therefore necessary to accumulate evidence that prices did not follow legitimate economic forces. One way to do this is to establish what the level of price or price relationships would

have been, or should have been, had the suspected manipulator not illegitimately interfered with the normal process of price formation. In establishing normative levels or price relationships, it is important to identify as many relevant market forces as possible and to ascertain their effect.

In the cash market for commodity assets, for example, one must consider supply factors such as the deliverable supply of a commodity as specified in the derivatives contract; any "seasonality" that may factor in its supply; all relevant production and marketing trends; and owners of deliverable supply. Likewise, one must identify demand factors such as the major users of a commodity; the location of the users relative to the delivery points of the commodity; changes in economic factors affecting the demand; and demand at the delivery points.

On the derivatives side, one must examine all aspects of open contracts, such as the group composition of the market (i.e. market shares of largest traders); who held derivatives positions of a size sufficient to affect prices; and who held large positions on the other side of the market. Finally, one must consider delivery factors such as who owned or controlled deliverable supplies; who made deliveries; who received deliveries; and what grade of asset was delivered and where it was located[9].

## 2. Investigating the possible distortion of the laws of supply and demand

As an early step in the investigation of a possible manipulation of the market for a security, a derivative contract or the underlying asset, it may be useful to determine whether or not the potential manipulator had the ability to influence market price or volume. This ability can stem from: (1) the manipulator's control of the supply of a security, or of the asset underlying a derivative contract, (2) the relative and absolute size of his derivatives positions, or simply from (3) his specific access to the public market, whether it is through the market itself, or through the Internet or some other medium in which he disseminates false information about the security, the derivative contract, or underlying asset.

### a. Establishing control of the available supply

In order to determine whether the suspected manipulator has control of the available supply of a security or of the asset underlying a derivative contract, it is necessary to establish the available supply, how much of that supply is publicly

[9] Other pertinent surveillance questions for derivatives markets are listed in the September 1998 IOSCO Technical Committee report entitled "*The Application of the Tokyo Communiqué to Exchange-Traded Financial Derivatives Contracts*."

traded or deliverable, and whether the security or asset is owned broadly by many different market participants. For example, the less liquid a security, the easier it is for a person to obtain control of supply without having to own a large proportion of the issued capital. The determination of who controls the available supply of a security or other asset may require analyzing the trading records, and taking steps to investigate who is behind the nominee names (where applicable) in which the security, derivative contract, or asset has been held and traded.

Manipulation cases may involve circumstances where the number of shares outstanding may be high or where the deliverable supply is ample, but the suspected manipulator may have designed and carried out transactions for the purpose of limiting the public float or deliverable supply and placing a large portion of the publicly-traded security or of the asset underlying a derivative contract in the hands of a particular entity or small group of entities.

In order to assess whether the suspected manipulator has control of the available supply, the investigator may wish to examine the available data on OTC transactions. OTC transactions may be used either to finance the purchase of the asset concerned (e.g., through repo transactions), or to carry out the purchase of such assets. It should be noted that in many jurisdictions OTC transactions are not subject to reporting requirements to regulators.

### (i) Securities

On the securities side, there are certain types of transactions that manipulators commonly use to gain control of the publicly traded shares of a company. Some of these transactions are described below, but it should be noted that not all of the following transactions, or the statutes and rules that they are designed to evade, are applicable to all jurisdictions.

Manipulators frequently initiate the manipulation by acquiring a dormant public corporation (“shell”) and merging it with a privately-held company. Manipulative schemes that begin with the acquisition of a public shell commonly involve reverse stock splits. The purpose of the reverse stock split is to reduce the number of authorized shares so that the shares can be better controlled by the insiders and there is less likelihood of a significant percentage of outstanding shares ending up in the public float.

Manipulators can also gain control of a public company via the initial public offering (“IPO”). For example, in a “blank check” type of scheme, a promoter/manipulator sells securities to the public, but the use of proceeds and business of a company are not determined prior to the IPO. The promoter and accomplices receive large blocks of control shares for nominal consideration prior to the IPO. The lead market maker for the securities acts in cooperation with the promoter and advances the bid, despite absence of legitimate demand and order flow. The market maker dominates the market through price leadership and control of the float. Through that domination and control of the market, and

through the use of materials to promote the security, the market maker and promoter are able to manipulate the price of the security.

A third method for the manipulators to gain control of the issuer or a large block of securities is more straightforward: if the manipulation is being carried out by management of the issuer, or if the manipulator is working closely with management, management may simply cause the company to issue unregistered securities in large quantities to themselves and to their co-conspirators through nominees. In doing so, they typically misuse various exemptions from registration requirements to avoid registering the securities. The exemptions from registration that are commonly abused include: (1) exemptions for securities issued by a company as compensation to advisors and consultants ; (2) exemptions for small offerings, or private placements ; and (3) exemptions for securities sold in a foreign country. After the security's price has been manipulated to the desired level, management and its nominees can sell their securities at a profit.

The above-described methods of gaining control of the supply of a security are examples only, and are not the exclusive means that may be used to achieve such control even in the jurisdictions to which they apply. The methods described, however, illustrate three techniques to place control of the security into the possession of the manipulators, and may be used in combination with one another.

#### (ii) Derivatives

In a "corner", involving derivatives markets, a market participant or group of participants acquires control of the available supply of the asset in the cash market and the derivatives market. The market participant or group of participants then requires those holding short positions to settle their obligations under the terms of their contracts either: by making delivery by purchasing the asset underlying the derivative contract from the manipulator; or by offsetting in the derivatives market opposite the manipulator at artificially high prices dictated by the manipulator. To establish control of the available supply of the asset, an investigator would need to determine the supply of the asset held or controlled by the suspected manipulator as well as the long positions directly or indirectly held by the suspected manipulator on-exchange and in the over-the-counter market.

### b. Establishing the ability to influence market price without controlling the available supply or demand

In some cases, the manipulator may not control the supply of a security or of the asset underlying a derivative contract, but may use various other means to

manipulate the price, such as disseminating false information about the relevant company or taking advantage of a congested market. False information about the company or the derivative or cash market, which influences the price of the company's shares or of the asset underlying a derivative contract may be disseminated in publicly filed financial statements, press releases, or through some other medium.

The Internet creates special challenges in fighting market manipulation: it is an efficient and quick way to reach large numbers of potential investors, and it is particularly significant in the international realm because it provides a new medium for fraud to be committed more easily across borders. For example, the owners or promoters of a company may set up a Web page with false financial information or false statements about the company's products. They can then use e-mail to contact as many investors as possible, using e-mail addresses that they have collected on the Internet, for the purpose of touting the company. The false information and touting may be spread further by the use of newsgroups and Web discussion sites dedicated to investing. Additionally, the Internet may allow individuals seeking to manipulate the market to act anonymously or to impersonate a legitimate source of information.

It also has become common for publishers of securities newsletters, which offer recommendations on particular securities, to publish their newsletters and recommendations on the Internet. The publishers of such newsletters may have been paid by the issuer or promoter, in the form of securities or monetary compensation, to tout their securities.

Finally, a manipulator who is not affiliated with the issuer can obtain a block of a security and then use Internet investment sites to disseminate false information about the security. He can then monitor the market prices and sell when the security reaches a sufficiently high level.

### (iii) Securities

In cases involving either unexplained increases in an issuer's share price, or the dissemination of potentially false financial or business information, the investigator should analyze the issuer's financial statements. Such analysis should include an examination of what assets support the company's security, whether those assets are real, a review of the company's earnings, both past and current, and an analysis of whether the financial statements support the price at which the security is trading.

In addition to analyzing the company's financial statements, the investigation should focus on whether the company has a current or proposed product that would justify the price at which the security is currently trading, or whether, instead, the product is bogus or in a preliminary, untested stage. In cases involving the manipulation of the securities of penny stocks or microcap companies, it is common to exaggerate or even fabricate potential and existing

demand for the company's product, and possibly the stage of development of the product.

#### (iv) Derivatives

In addition to disseminating false or misleading market information, a participant could potentially manipulate the price of a derivative contract or the underlying asset without controlling the available supply by exacerbating market congestion caused by a naturally occurring shortage of the asset. In such a "squeeze," the manipulator has the ability to influence prices by increasing his/her long position in the derivatives market. As the shorts enter the delivery period and realize that they do not hold sufficient supplies of the asset to satisfy the demands of the longs who stand for delivery, the shorts will bid up the price of the derivative contract and/or the asset to the point where it becomes economically viable to divert supplies from normal commercial channels to delivery points. In an effective squeeze, shorts will have to offset at least part of their position in the derivatives market at artificially high prices dictated by the longs.

### 3. Proving intent

#### a. Nature of intent

Not all jurisdictions require intent or proof of intent in order to establish manipulative conduct. When intent is a necessary element to prove manipulation, some jurisdictions focus primarily on whether the conduct at issue was done with fraudulent intent or with the intent to mislead. Other jurisdictions require proof of intent to create artificial prices.

#### (i) Fraudulent intent/intent to mislead

In many jurisdictions, certain manipulative conduct is defined as conduct involving an intent to defraud or create a false impression in the minds of market participants. This is especially (but not exclusively) true of criminal codes that address manipulative conduct.

#### (ii) Intent to cause artificial prices

Some jurisdictions focus on the intent to cause artificial prices for certain types of manipulative conduct. The intent to cause artificial prices alone, even in the absence of fraud or deceit, may be considered manipulative. Proving the intent to cause artificial prices in the context of derivatives trading may require that a regulatory authority or prosecutor demonstrate that a market participant did not simply exploit the benefits of a legitimately established positions in advantageous market conditions. Where the market participant holding the long position exacerbates market congestion by intentionally decreasing the deliverable supply or increasing his/her long position in the derivatives market, manipulative conduct might be inferred.

### b. Establishing un-economic behavior – refute legitimate business purposes

In establishing intent, the regulatory authority or prosecutor might have to refute arguments that activity undertaken by a suspected manipulator actually serves a legitimate economic purpose. Accordingly, the investigation should include a comparison of the trading or quotation activity to the workings of supply and demand -- prices should not be going up if there is no real demand for the security or asset.

In the securities context, the market participant can be asked if there is any economic justification to be provided for the trades. The investigator should examine the number of times the market participant raised the bid during the relevant period, and examine whether that bid was the leading, equivalent, or lower bid compared to other market makers. Also, the investigation should review those records for evidence that the entities responsible for raising the price had any orders to support their bid and ask quotations. For example, if a market maker raises its bid for 20 days in a row, and yet never did a trade during that time, that would be an indicator of market activity without economic substance, and suggestive of manipulative activity.

For trading in securities, the records should be examined for purposes of determining whether there were any trades outside the quotation. Purchasing by a market participant below its own quotation may be suggestive of manipulation, especially when it is raising the bid price at the same time.

The market participant's inventory should also be studied, including the opening and closing inventory figures. If the firm had a policy regarding acceptable inventory levels to be carried overnight in that type of security, the question is whether that policy was followed. Another important question is whether there were orders to support the inventory level that the firm maintained in the manipulated security. If the market participant is carrying more of the manipulated security in inventory than normal or justifiable, he may be seeking to lock up the floating supply of the security in question.

With respect to derivative contracts that allow for delivery of the underlying product, it will be important to consider whether a legitimate purpose can be established for delivery, such as whether the party seeking delivery has fixed price sales obligations to deliver in the cash market.

### c. Showing motive for affecting market price of a security or creating appearance of active trading in a security

The usual motivation of participants in a market manipulation is to make money on the sale of the securities being manipulated. To establish such motivation, the investigator may demonstrate ownership by the manipulators and their nominees

of a large block of a security or an options position, to be sold at an inflated price. In certain jurisdictions, manipulators also may profit during the offering phase, as well as in the secondary market. For example, offering proceeds may be increased by manipulating the market price on which the offering will be priced. Although motive is not always a necessary element of the manipulation offense on the derivatives side, the manipulator may have a large derivatives or cash position that would benefit from a price movement.

Another possible motivation is the existence of a relationship between entities that may be cooperating with one another from one deal to the next. For example, one broker may be motivated to help with a scheme to manipulate in order to obtain the other broker's cooperation in a future manipulation.

Another possible motivation is the desire to inflate the value of the assets in a portfolio or fund. This goal may motivate fund managers to participate in a manipulation.

Finally, in some manipulative schemes, the issuer, promoter, or other insiders may be paying bribes to the brokers who are carrying out the manipulative trading. In boiler room operations, the broker may be using some of that money to hire relatively new, inexperienced, or unsupervised brokers to make cold calls on potential customers using high pressure sales techniques and using sales scripts.

### *B. Maintaining and Collecting Information Necessary to Prove Manipulation*

#### 1. Record-keeping requirements/reports from self-regulatory organizations, exchanges and intermediaries

The investigating authority should take advantage of the record-keeping requirements that exist in the relevant jurisdiction. Depending on the circumstances, such as the type of scheme and the parties involved, and the market and trading mechanisms involved, the following types of records should be considered: trading records concerning transactions relating to the security, derivative and/or asset the price of which is being manipulated, including but not necessarily limited to order tickets, confirmations, monthly account statements, trading books, canceled checks, wire transfers, financial instrument ownership transfers, stock transfers, and any other related documents. In addition, data can be obtained from clearing organizations and central depositories. The identity of account holders and beneficial owners of the securities and derivatives positions is important, in order to identify the customers on whose behalf the trading is being done. It may also be important to obtain the telephone records of the account holders and beneficial owners of the securities or derivatives and any taped telephone conversations between intermediaries and their clients.

The investigator may also need to obtain the trading and telephone records of others who are potentially involved in the manipulation, such as the promoter, the issuer and its management, purchasers, transfer agents, investors, other brokers, and anyone else who may be involved in the scheme. In a case involving the Internet, the investigator may need to seek the information from an Internet service provider or other sources concerning e-mail senders and recipients as well as authors of Web pages.

Another important source of documentation concerning the suspected manipulative trading is the records and audit trails of stock exchanges and, when applicable, self-regulatory organizations. For example, the following types of reports and analyses (among others) may be available, or may be generated from trading data: (1) market maker price movement reports, which may show quotation advances, wide spreads, marking the close, one market maker leading other market makers, and frequent closing quotes; (2) high bid and low offer analysis, which shows the percentage of time a broker firm held the exclusive and shared high bid or low offer among all market makers in the security; (3) reports showing total reported volume and the volume reported by each market maker, on a daily, weekly, or quarterly basis; (4) reports that compare every trade effected in order to determine whether the trade was executed within the inside quote (*i.e*., highest bid, lowest offer); (5) security watch reports, which will show activity in the market that has caught the attention of the self-regulatory organization or exchange that generated the reports; and (6) marking the close alerts, which will show if a security's closing price has traded outside certain parameters on a frequent basis within a particular time period.

As regards derivatives exchanges, the following types of information may be available, collected or derived from trading data: (1) pricing of contracts throughout the trading day in real-time; (2) transactional information including date of trade, commodity contract, delivery month, expiry date, buy/sell, quantity, counterparties to the contract and price of the contract; (3) positions held by market members (both "whole firm" and individual participants) and market users where the size of the position is above a specified level; (4) the identity of each position holder (by name or code) down to first customer level and the size of the position, by contract month, for each position holder; (5) warehouse stocks or other deliverable supply; (6) OTC transactional information including date of transaction, interest, duration and maturity of contract, buy/sell, quantity, counterparties to the contract and price of the contract; (7) OTC position information; and (8) delivery intentions.

### 2. Bank records

It may be important to obtain bank records of the various entities and persons involved in the trading of a security, of a derivative contract or of the asset underlying the derivative contract. Such records may reveal or suggest the existence of payoffs, bribes, the splitting of profits or mutual financing arrangements. The bank records also are likely to be necessary in order to trace

the proceeds of the manipulation and eventually obtain a forfeiture or freeze of the assets.

### 3. Telephone records

The telephone, facsimile, and e-mail records of brokers, customers, investors, insiders in a company, and/or the promoter may reveal information about collusive trading or other manipulative activities.

### 4. Use of regulatory powers to collect information

The investigating authority may use its various regulatory powers to obtain the types of information discussed above. The various information-gathering powers of the securities or derivatives regulator, or reporting requirements applicable to regulated entities and market participants, may include the following: (a) mandatory position reporting; (b) power to inspect records of registrants and licensees; and (c) power to require hearings or the production of testimony and records from investors, customers, and third parties such as banks and telephone companies.

## VI. THE CHALLENGES IN TAKING ENFORCEMENT ACTION AGAINST MANIPULATION

### A. Standards of Proof

In many jurisdictions, there is a different standard of proof for civil, administrative, and criminal actions, with the highest standard of proof required for criminal proceedings. In all three types of cases, it will often be difficult for the regulatory authority or prosecutor to obtain direct evidence -- either through documents or testimony -- of manipulation. In some cases, the regulatory authority or prosecutor may be able to obtain such direct evidence, such as the testimony of a co-conspirator that he/she and the defendant intended to manipulate the price of a certain security, derivatives contract or asset underlying the contract.

More commonly, however, the manipulation case will have to be based upon circumstantial or indirect evidence and inferences based upon that evidence. Such inferences may be based on patterns of conduct, the fact that a defendant has a pecuniary interest in a given security, derivatives contract or underlying asset, the defendant's having taken steps to effect a rise in its price and the trading patterns or irregularities that emerge from an analysis of the trading data.

### B. Reconstructing Trading in the Market

Trading reports and audit trails from exchanges are good starting points for the reconstruction of trading, from which significant patterns may emerge. Some of the types of analyses and reports available from exchanges and self-regulatory organizations are listed in Section V.B.1. These documents will provide evidence of who was in the market, what possible conditions might have contributed to price movements, and the timing and patterns of the price and volume movements in relation to other occurrences and influences (such as corporate developments, commodity statistics issued by a governmental authority and public announcements of the issuer).

It is important for audit trails to capture the whole course of market trading including timing and sequencing of transactions from the time of order receipt through execution, confirmation and clearing.

In addition, in connection with a potential manipulation of the price of a security, the regulatory authority or prosecutor may want to obtain, and may rely on, offering circulars, prospectuses, disclosure documents, and various other public filings. In addition to publicly filed documents, the proof of manipulation may also include promotional literature and press releases.

### C. Voluminous Data Management and Analysis

If all of the relevant trading records are obtained, as well as bank records, corporate documents, and other records, the volume of data and documents may become significant. As a method of organizing the evidence, and in order to demonstrate the likely manipulation, it may be useful to prepare charts showing price and volume history for the applicable period for the relevant security, derivatives contract or underlying asset, or to obtain such charts from commercial market data collection organizations. In addition, when the manipulation case is based on trading, the regulatory agency or prosecutor will need to prepare, when the data are available, a chart of transactions reconstructing the market showing counterparty, price, moving inventory of the market participant, and profits or losses to the trading account on long sales and purchases and on short sales. In addition to charts, investigators may consider using statistical analysis to demonstrate the existence of intention and to refute a claim that the trading was for legitimate business purposes. Both in-house and independent consultants and experts (including academics) can help to organize and analyze the data.

### D. Use of Expert Testimony

Expert testimony, either delivered by outside experts or by experts from within the relevant securities or derivatives authority, may be useful to explain to the trier of fact what the patterns of trading are and why they are indicative of manipulation. Also, depending on the rules of the particular jurisdiction, the expert may be used as a shortcut way of getting the trading data into evidence or before the trier of fact as material relied on by the expert in reaching his opinion.

Experts with actual and current experience from the marketplace can assist investigators both during investigations and prosecutions by providing explanations of what would be considered "normal" market behavior or "legitimate" business activity. Such expertise can assist the investigator in closing investigations that are not warranted and in identifying evidence useful to refute defenses asserted during prosecution.

Depending on the procedural rules of the jurisdiction, there may be limitations on how far the expert witness will be permitted to go in drawing conclusions as to whether there was a manipulation based on the trading patterns and other facts.

## VII. COOPERATION

There are many instances in which a regulator must seek assistance, whether domestically or internationally, to obtain relevant information regarding market manipulation. For example, information on manipulative activities may be in the possession of or may only be obtained by another regulator or authority. Also, multiple regulators and authorities can prosecute the same manipulative activity, and sharing information is an efficient use of resources. Therefore, cooperation among regulators and authorities can be useful and may be necessary in detecting suspicious market activity and in investigating and prosecuting market manipulation.

Cooperation exists on different levels. In particular, information sharing takes place between exchanges; between regulators; between a regulator and an exchange; and between a regulator and other types of authorities. Forms of cooperation include sharing information already in one's possession in response to a request, compelling an individual or entity to produce information (e.g., documents or statement) in response to a request, and proactively providing information to a relevant party.

### A. Domestic Cooperation

Cooperation can take place on a domestic level where, for example, an authority other than the regulator (e.g., exchanges) shares responsibility for market surveillance. Cooperation also can take place where an authority other than the regulator has the ability to obtain or compel relevant information (e.g., criminal authorities). Many jurisdictions have established procedures domestically for sharing information about manipulative activity between the relevant parties/authorities.

#### 1. Cooperation between exchanges

In some jurisdictions, exchanges may be in a primary position to detect and prevent manipulative activity. This is because some exchanges have self-regulatory responsibilities whereby each exchange monitors the daily activities of its market and supervises its market and participants to ensure compliance with

domestic laws and regulations. Such exchanges are viewed as being in an advantageous position to monitor for manipulative activities and to share relevant information proactively with other affected exchanges. Thus, sharing of market surveillance information and other exchange-to-exchange cooperation play important roles in combating manipulation.

Exchanges may have the ability to share information informally with one another or on a case-by-case basis. Under such informal arrangements, exchanges may notify each other of manipulative activity proactively or upon request. There may be formal mechanisms under which exchanges share information. One example of such formal mechanisms is the Intermarket Surveillance Group (ISG)[10].

The ISG provides a framework under which exchanges share information regarding related products and market surveillance, and otherwise coordinate regulatory efforts. The ISG was created by the major U.S. exchanges as a domestic effort toward sharing information and discussing common regulatory concerns. Since its creation, the ISG has expanded its membership to include major securities exchanges and derivatives exchanges worldwide where these exchanges also have self-regulatory responsibilities.

Participation in the ISG requires a commitment by each member to share with other members information that is useful to the investigation of trading violations. When an ISG member, through conducting market surveillance on its own marketplace, has a reasonable basis for believing manipulation has occurred, that member will review consolidated ISG data to determine if the manipulation occurred across more than one market. If other markets are affected, the member will coordinate an investigation with any other ISG member, as appropriate. This coordination enables members to avoid duplicative efforts.

Information sharing within the ISG is subject to certain conditions. For example, information is shared as needed and upon request. Also, confidential information must be kept confidential and used only for regulatory purposes.

While the ISG is comprised of international members, domestic information sharing also takes place within the membership since several members are located in the same jurisdiction. By sharing such information with other members, exchanges are on alert to potential manipulation and other illegal activity that could affect the markets on a domestic level.

[10] The following exchanges are members of the ISG: Alberta Stock Exchange, American Stock Exchange, Amsterdam Exchanges, Boston Stock Exchange, Brussels Exchange, Chicago Board Options Exchange, Chicago Stock Exchange, Chicago Board of Trade, Chicago Mercantile Exchange, Cincinnati Stock Exchange, London Stock Exchange, Montreal Exchange, National Association of Securities Dealers, New York Board of Trade, New York Stock Exchange, Pacific Stock Exchange, Philadelphia Stock Exchange, OM Stockholm Exchange, Toronto Stock Exchange, Vancouver Stock Exchange.

### 2. Cooperation between exchanges and regulators[11]

Information sharing between an exchange and its regulator plays a crucial role in detecting, investigating and prosecuting manipulative activity. As noted above, exchanges may be in an advantageous position to gather market surveillance information and other information on manipulative activity. Some exchanges can use this information to investigate the conduct of their members and take necessary disciplinary action. Where an exchange does not have investigative authority or where the conduct involves a non-member, information gathered by the exchange relating to manipulative activity may be useful to its regulator.

Many exchanges are under statutory obligation to provide information to and otherwise cooperate with their regulators. Such exchanges often work closely with their regulators to assist in building investigations relating to manipulation and other illegal activity. Also, an exchange may have technical expertise and resources that are unavailable to the regulator. In those instances, the cooperation of an exchange contributes greatly to a regulator's efforts to investigate and prosecute violations of domestic securities and derivatives laws.

Where the obligation to provide information does not exist, a jurisdiction should review and amend its legislation to give the regulator the authority to compel such information. This authority is essential for a regulator to gather sufficient information to combat manipulation.

### 3. Cooperation between regulator and other authorities

There are occasions when authorities that are not securities or derivatives regulators or exchanges hold relevant information. For example, law enforcement, banking and other authorities may possess or have the ability to gather certain information relating to manipulative activity. It may be necessary for regulators to follow special routes to obtain the information from other domestic authorities.

With respect to cooperation between regulators and domestic law enforcement authorities, in some jurisdictions, manipulation can be both a civil/administrative and criminal offense. Often in these jurisdictions, regulators consult regularly with domestic law enforcement authorities and frequently refer cases to each other. They also may share non-public information subject to its confidentiality treatment.

In other jurisdictions, regulators are required to refer manipulation cases to their domestic law enforcement authorities. These regulators' primary role is

[11] TCWG-4 received the assistance of several exchanges and self-regulatory organizations throughout this project. Representatives from the London Stock Exchange, the National Association of Securities Dealers – Regulation, the New York Stock Exchange and the Chicago Board of Trade made presentations to the group concerning their surveillance and enforcement programs.

investigating the manipulative activity, while the criminal authorities have responsibility for the prosecution of such offenses.

## B. International Cooperation

Cross-border trading, multiple listings and globalized markets have increased the need for international cooperation in detecting, investigating and prosecuting manipulative activity. Because manipulative activity can easily overcome international borders, it is essential that regulators and other authorities have the ability to share information internationally.

Information sharing internationally may take place pursuant to informal or formal mechanisms. Some authorities have the ability to share information directly with a regulator. In other cases, regulators may be able to access information about manipulative activity indirectly from a third party.

Regulatory cooperation may be enhanced when a regulator has the legislative authority to obtain information on behalf of its foreign counterparts in order to share it with them. This authority may include, for example, a regulator being able to share information in its files in response to a request from a foreign regulator; compel an individual or entity to produce information (e.g., documents or testimony) requested by a foreign regulator; and proactively provide information to the foreign regulator. Often, when negotiating formal arrangements, regulators may be required to confirm that they have legislative authority to assist their foreign counterparts.

### 1. Cooperation between foreign regulators

Cross-border manipulation creates challenges for foreign regulators. Information necessary to determine whether manipulation occurred or to support an action against manipulative conduct may be located in another jurisdiction. Additionally, investigations in multiple jurisdictions may arise as a result of the cross-border conduct. Consequently, it has been well established that international cooperation is essential to a regulator's efforts to detect, investigate and prosecute cross-border manipulation.

Cooperation can be undertaken informally or pursuant to formal, written arrangements. Generally, effective information sharing requires regulators to ensure that they have the ability to collect, to share information and otherwise to cooperate with their counterparts.

#### a. Memoranda of understanding (MOUs) and other formal arrangements

Formal arrangements, such as MOUs, do away with the need to negotiate assistance on an ad hoc basis. Formal arrangements provide established mechanisms by which regulators may obtain information on manipulative activity and other offenses from their foreign counterparts. The arrangements may also

establish the conditions under which information provided in response to requests is used and to what extent the information must be kept confidential. While the arrangements may not be legally binding, the arrangements express an intention by like-minded parties to use their best efforts to provide assistance to the extent possible under domestic law.

Under these formal arrangements, regulators often make requests to their foreign counterparts to obtain information regarding manipulative activity. The arrangements may also provide procedures under which a regulator can proactively notify a foreign regulator of information of interest. Finally, where there are investigations in multiple jurisdictions relating to the same manipulative conduct, the arrangements may lay the basis for foreign regulators to work closely on their respective investigations.

### b. Case-by-case arrangements

Regulators often contact one another to request information and other assistance with cases involving manipulative activity. Many foreign regulators are able and willing to assist their counterparts even in the absence of formal information sharing arrangements.

In considering a request for assistance, foreign regulators may take into account factors such as a requestor's willingness and ability to reciprocate and to keep privileged information confidential. Many times, a foreign regulator will limit use of the information to regulatory purposes or require the requestor to notify the foreign regulator if the information will be used in a manner inconsistent with the original request. A foreign regulator also may require the requestor to sign an undertaking, which requires the requestor to agree to certain conditions in order for cooperation to take place.

## 2. Cooperation between regulator and others

Frequently, securities or derivatives regulators seek the assistance of their foreign counterparts. However, there are circumstances in which the regulator may need to obtain the information from other authorities, such as foreign law enforcement authorities. For example, there may be no securities or derivatives regulator in the foreign jurisdiction, or if one exists, it may not have the power to compel the production of information on behalf of a foreign regulator. In such cases, the involvement of other foreign authorities may be helpful.

Cooperation between securities and derivatives regulators and other types of authorities is important. There are instances where information may be shared directly between regulators and other foreign authorities. In other instances, different mechanisms may be used.

### a. Direct cooperation

Some regulators have been able to work directly with foreign authorities in matters involving manipulation. For example, in some jurisdictions, legislation explicitly allows a foreign authority to assist regulators. In other jurisdictions, language in legislation is interpreted to allow authorities to share information with a foreign regulator.

### b. Indirect arrangements

Regulators also can obtain the assistance of foreign authorities indirectly by working closely with domestic authorities. For example, domestic law enforcement authorities on behalf of the domestic regulator can request the assistance of foreign law enforcement authorities through mutual legal assistance channels. Close cooperation between the regulator and its domestic criminal authorities is necessary when the regulator requests information through these channels.

### c. Assistance through counterpart regulator

Foreign regulatory counterparts can play an important role in facilitating information sharing between a regulator and a foreign authority. For example, the foreign counterpart may better understand the regulator's need for cooperation and may have useful contacts with foreign authorities. Also, the foreign counterpart may be able to assist in framing the request to the foreign authorities to make it more likely that a positive response will be received and to expedite the response.

## 3. Cooperation between regulators and foreign exchanges

There are instances where a regulator may work directly with foreign exchanges in matters involving manipulation. Because regulators sometimes delegate specific supervisory authority to their exchanges, exchanges in the first instance may possess information that their regulators generally may not have on file. Some exchanges are legally permitted and willing to share such information with foreign regulators.

Where a foreign exchange does not have the authority to share information on manipulative activities directly with a foreign regulator, it may be possible to obtain the foreign exchange's assistance indirectly through the exchange's regulator. The exchange's regulator may have the authority to request or to compel the information from the exchange on behalf of the requesting regulator.

The Declaration on Cooperation and Supervision of International Futures Exchanges and Clearing Organizations (Boca Declaration), March 1996, and the accompanying MOU provides a multilateral framework for cooperation between exchanges and foreign regulators, including information sharing regarding possible manipulative activity. The Boca Declaration encourages international

information sharing among exchanges, clearing organizations and regulators and plays a significant role in addressing cross-border manipulative activity.

### 4. Cooperation between foreign exchanges

Where manipulative conduct affects multiple jurisdictions, information sharing between an exchange and its foreign counterpart is one mechanism for detecting and combating cross-border manipulation. Exchanges that have the authority to survey their markets may be in the best position to monitor for manipulative activity through such surveillance. Accordingly, these exchanges also may be in the best position to notify other jurisdictions immediately of manipulative activity affecting their markets.

Some exchanges have the ability to share information informally with foreign exchanges either upon request or proactively. Additionally, negotiated arrangements for exchange-to-exchange cooperation exist and can provide procedural mechanisms by which information may be shared. Two examples of such arrangements include the Companion Memorandum of Understanding to the Boca Declaration and the ISG.

#### a. Companion MOU to the Boca Declaration

The exchange MOU that accompanies the Boca Declaration constitutes an international, multilateral arrangement for sharing information on a bilateral basis between the requesting and requested derivatives exchanges and clearing organizations consistent with their legal and contractual obligations. The documents establish mechanisms whereby the occurrence of certain agreed triggering events relating to an exchange member's financial resources or positions will permit the sharing of information upon request under the MOU. The trigger levels are designed to facilitate the identification of large exposures by firms that could have a potentially adverse effect on markets.

The Boca Declaration itself serves as an acknowledgment by supervisory authorities that regulated exchanges may ask them to make information available to another supervisory authority where appropriate, and may be requested to facilitate exchange-to-exchange information sharing in instances where laws impede an exchange from communicating with a counterpart directly.

#### b. ISG

As noted above, the ISG provides a multilateral framework for cooperation between exchanges with self-regulatory responsibilities, including information sharing regarding possible manipulative activity. Because the ISG encourages information sharing among its international membership, the ISG plays an important role in facilitating international efforts to combat manipulation. When one member detects potential cross-border manipulative activity, the ISG provides procedures through which the member can notify its foreign counterparts and coordinate investigations.

## VIII. RECOMMENDATIONS

Securities and derivatives regulators charged with enforcing laws, regulations and rules that prohibit manipulative conduct should have:

- effective tools to prevent and detect manipulation, including laws that proscribe manipulation with sufficient clarity and flexibility to allow prosecution of novel manipulative schemes ;

- adequate authority to investigate, prosecute, and deter market manipulation and/or the ability to work with other domestic authorities that investigate, prosecute and deter market manipulation ; and

- the ability to cooperate at all stages of a matter — from surveillance, through investigation, to commencement of an action — across markets and across borders.

# ***Nature's Finest.***

**Part 1**

"Nature's Finest" (NF) had been producing bottled water for more than 100 years. The water source was a free flowing spring coming out of a rock outcropping in the highlands of Nanda, a middle-eastern nation. The spring had been known for hundreds of years as "Lifesaver" by residents of the region -- a source of fresh water to countless thousands of people. Lifesaver water had an almost mystical quality to the populace. Control of Lifesaver had been the object of tribal wars over the centuries, and finally had been secured in the 19th century by the then King of Nanda. The Kingdom experienced many political and economic changes over the following century, including occupation by the Ottoman Empire and the British Empire, but the critical need for fresh water, coupled with the political skills of NF's management family enabled NF to continue production despite the changing times. Nanda became an independent sovereign nation in the early 1950's. Ownership of NF was transferred to the Government of Nanda at the time of Nanda's independence. Nanda transformed over the next 40 years into a democratic society, with excellent ties to the western economies, and with equally strong political and economic ties to most surrounding nations.

The primary economic strengths of Nanda were agriculture and tourism, both complimentary to the business of NF. NF was the largest single non-infrastructure company (i.e. utilities, transportation, communication type businesses) in Nanda. Over the years, NF modernized the bottling plant facilities and increased distribution throughout Nanda, and into neighboring nations. NF was an extremely important source of revenue to Nanda, and was reasonably well operated, despite the usual political pressure to employ "favored persons."

NF progressed and prospered from the stability of Nanda. A small capital market had evolved, mostly associated with trading Government issued notes and bonds, with shares of a few publicly owned companies trading as well. NF had been an issuer of medium and long term bonds which were traded on the Exchange, but remained a wholly owned Government entity. Investor interest was largely from Nandaian nationals, plus some investment activity from neighboring nations. The Nanda Stock Exchange (NSE) was formed by broker-dealers to facilitate trading, following models of other emerging market nations.

In the 1980s, western investment bankers approached the Government about privatizing some or all of Nanda's government owned enterprises. Intrigued by the prospect of attracting investment capital to Nanda, it was agreed to privatize NF. Nanda employees were allocated twenty percent of the shares of the company in the form Class "A"

restricted sale (could not be sold until two years after the public offering) to be distributed according to a formula that took into account the salary level and seniority of each employee; twenty-nine percent of the shares were retained by the Government in the form of class "B" preferential dividends; and fifty-one percent were set aside as class "C" shares for distribution to public investors, the distribution to be priced by negotiation with the investment banking coalition. The pricing negotiations were strident. NF and Government negotiators were seeking "aggressive pricing." Eager to "get a foot in the door", the underwriting coalition finally agreed to pricing at the equivalent of a price to earnings (PE) ratio of 30, twice the PE of multinational bottling companies at the time.

The public offering price was set at the equivalent of $US 10. Despite the high PE, the magic of the Lifesaver name, plus NF's long history of successful production and growth provided the basis for a hugely successful public market for NF stock, the price rising almost immediately to $US 20. After a slight pull back as initial investors "took their profits", the stock price continued to rise over the next two months to nearly $US 50. Trading in NF stock became so frenetic that the NSE fell far behind in clearing and settling trades. The public was clamoring for more shares, and an active curb market evolved, with shares being traded "on the spot." Broker-Dealers were seen on the curb trading after NSE trading hours. The "man on the street" entered into the stock market for the first time, often investing life savings in the expectations of fast gains. NF employees were euphoric, and while they were unable to sell their shares, many used the increased value of the shares as collateral for loans to purchase automobiles and other consumer luxuries.

Rumors were everywhere, discussed at every corner, over every cup of coffee: "NF is being acquired by Coca-Cola;" "NF has negotiated a contract with Schweppes to sell Lifesaver water in Europe;" "NF has expanded capacity by drilling deep wells to the source of the Lifesaver spring."

Counterfeit shares appeared in the market, and the NSE was faced with the additional problem of resolving disputes over counterfeit and actual shares, while attempting to catch up with its clearing and settling problems.

And eventually, the denials. No increased capacity, no negotiations with Coca-Cola or Pepsi or Schweppes, just business as usual. Soon other rumors began: "The Government is selling its remaining twenty-nine percent share;" "Senior Management sold most of their holdings;" "Evian bottled water is entering the Nandaian market at lower prices."

NF share prices fell dramatically, and within days were worth less than half of the value at the peak of the market. It appeared that share prices would continue to drop as investors had lost all confidence in the market.

Alarmed by the chaotic behavior of the market, and prodded by the outcries of the public, the Nanda Capital Markets Administration (NCMA) . . . .?

## Nature's Finest. Part 2

Ten years later.

Imran had been CEO during the original public offering of the common stock of NF, and had both profited and been disgraced by the soaring price and eventual collapse of NF's market value. He had sold much of his holdings during the price rise bubble, and thus acquired significant gains. Despite widespread belief to the contrary, no real evidence was developed to prove that he or his corporate officers were party to the "share scam" as it came to be known, but the scandal was so great he was forced to resign. He retained his profits and remaining shares in NF, and that enabled him to continue as an influential member of Nanda's political life.

The family was so strongly associated with the success of NF, and so closely aligned with the political leaders of Nanda, that his son was selected to be the subsequent CEO, over strong objections from the press and public. Nanda and the region had experienced political and economic unrest during the ten years of his management, and a great deal of his time was devoted to steering NF through the regulatory and political backlash from the share scam. He proved to be a capable, albeit conservative manager. He managed NF quietly, accepting the market share it held, working primarily to increase distribution and production efficiency. The share scam left deep scars on the employees and outside public investors, many of whom had lost most of their assets as a result of collapsed share prices. Employee strikes and political protest became an almost constant event at NF for the first few years of his management and he worked hard to restore their confidence with only modest success. His was, however, a benign management, largely a custodian of the great company created under the leadership of his ancestors.

During the ten years of his management, many capital market reforms had taken place. The Nanda Stock Exchange (NSE) had automated, a securities depository had been created, settlement and clearance had been automated, shares in many leading issuers including NF largely had been dematerialized. The Nanda Capital Markets Administration (NCMA) had been restructured, with new enforcement powers granted. The reforms did not seem to have much effect on NF, so long as they submitted timely financial statements.

NF share prices had stabilized around $US 5, half the original offering price of the stock. Company growth had flattened, and NF shares were trading at a PE of 10. Shareholders and the political leadership representing the Government's twenty-nine percent share were applying great pressure to increase the value of the company. It was at this point that he decided it was time to step aside for his son to succeed him as CEO, while retaining the title and position of Chairman of the Board. He discussed this decision with the members of the Board of Directors, and they agreed to the transition.

NF's stock price increased to $US 6, with activity noticed from domestic sources as well as western institutional interests.

Sayed was 45 years old. His ancestors had been the managers/operators of NF for nearly 100 years. He had been groomed for leadership of NF from birth -- educated at prestigious institutions in Great Britain and the United States, exposed to every facet of NF business -- production, marketing, finance, employee relations – in preparation for his ascension to CEO.

He had been planning for this time for years. He had a much different view of NF's future than did his father – and for that matter, most of the Board of Directors. He saw increased competition from lower cost albeit lower quality water bottlers – both domestic and foreign. NF had been barred from some markets when former user nations had developed protective tariffs for their bottling companies. Nanda's population growth was less than two percent per year – hardly enough to sustain his hopes for business growth exceeding twenty percent per year. How, then, to grow NF?

Sayed had some ideas, but he knew it would be difficult to get a commitment from his father and the Board of Directors to go with some of them. He believed it would be easier to convince the Board of Directors if he could engage third parties and the press to discuss the feasibility of his ideas. His ideas included: 1) using a lower cost/quality bottle, saving three percent on production costs; 2) persuading the Government to institute tariff protection in retaliation to other nations' blockading NF exports; 3) creating a palatial spa on the grounds of Lifesaver spring, hoping to attract wealthy tourists coming to Nanda to view the archeological wonders of the region. This would require far more start-up capital than NF would be able to supply, and he hoped to create an association with an internationally recognized resort operator. The only other way to raise sufficient capital for the project would be a secondary stock offering, and he felt the stock price would have to be much higher than it was currently for that to be an acceptable alternative to the Board of Directors.

Sayed first had a talk with his father and one of the Board members that had excellent political connections, and might have some ability to influence the Parliament about enacting protective import tariffs. Sayed's father was effusive with praise for his son's initiative.

NF's stock price continued to increase slowly, with occasional spikes in volume, but with no discernible pattern to the trading. Brokers reported most of the trading seemed to come from domestic sources.

Sayed next gave a formal presentation to the Board of Directors to "explore the feasibility of using a lower cost/quality bottle." He met strong vocal resistance, claiming it would destroy the image of NF, and degrade the reputation of Lifesaver spring. Sayed was not surprised at this reaction, so he next proposed to create a subsidiary company using the lower cost bottle, using surplus Lifesaver water, using the existing production and distribution network, but would be marketed not as "Nature's Finest" or using the Lifesaver name, but by some other generic name. A third possibility was the production of "private label" bottled water for sale to commercial interests in Nanda, such as Office Buildings and Hotels. The bottled water would be produced by the same production line, but using bottles with private labels rather than Nature's Finest labels. The proposals were sufficiently intriguing that the Board of Directors finally agreed to fund the

feasibility studies for all three possibilities. Requests for Proposals were prepared and distributed to internationally known engineering and marketing consultants. The Board decided that the news of the proposal was "confidential" and believed that releasing the news might have a negative impact on the high quality and standards of the NF name.

NF's stock price continued to increase, with occasional spikes in volume, apparently coming from the regional investors, Europe and the United States.

Sayed really felt that his idea to create a palatial spa was the most likely to benefit NF, and to increase share value. He asked friends to recommend a travel writer to him, and scheduled a meeting with the writer. During the conversation with the writer, he brought up the possibilities of tourism in Nanda, and posed the question "do you think a resort would aid tourism in Nanda?" The writer had been to many resorts throughout the region, and was enthusiastic about the possibility of one being created in Nanda, and said he would begin researching the story and would hope to get an article published in the local newspapers.

The University in the United States that Sayed attended was having a reunion of his class, and he decided to attend. One of his good friends from that class had become an "International Spas" executive, and Sayed sought him out to discuss his idea of a spa/resort at Lifesaver spring in Nanda. His friend thought it would be a great idea, and agreed to take the idea to the International Spas resort planning team. It was a good reunion, and both Sayed and his friend shared the possibility of an International Spas/NF resort in Nanda with classmates -- even jokingly suggesting the next reunion be held there! Sayed made a decision to not discuss this possibility with his father or the Board of Directors until he heard back from his friend at International Spas.

Another of Sayed's classmates was employed by a Wall Street trading firm, and led the initiative at his firm's trading desk to create an "American Depository Receipt" (ADR) to be listed on the NASDAQ trading market. Trading volume in NF began increasing dramatically, and the share price climbed to over $US 20. Brokers were reporting buying volume from domestic, regional and US sources.

Suddenly, Sayed realized the opportunity to raise additional capital through a secondary stock offering. At the urging of the US based Investment Banker he engaged, he also engaged a "big six" international accounting firm, believing that the big six reputation would help with the offering. Working with the investment banker and the accounting firm, the determination was made to offer subscription rights to purchase the new shares at a fixed price slightly below the current market to existing shareholders, plus a backup underwriting of the unsubscribed shares from investment bankers. NF filed registration papers with the Nanda Capital Markets Administration (NCMA), and instantly trading began away from the exchange for the subscription rights on a "when as and if issued" basis, despite the fact that the NCMA had yet to approve the offering. A new curb market had emerged, and the trading was frenetic.

Fearing another share scam, the NCMA …..?

As you read and study this case, consider these questions, while at the same time asking yourself about the regulatory implications of the various activities. If you think there are regulatory violations, what should be done about them?

## Part 1

How do you suppose the management family continued to remain control during these major changes in the Nanda political circumstances?

Do you think the pressure to "employee favored persons" to be significant, and if so, how would that affect the management and operation of NF?

Was it likely that the Nanda Stock Exchange had regulatory standards and practices in place? If not, why not?

What do you think about the pricing of the NF IPO?

Why do you think a curb market formed for the trading of NF? Do you think a curb market should be allowed, and if so, should it be regulated? How should it be regulated? If you think a curb market should not be allowed, why not? How can you prevent it?

How do you deal with inaccurate rumors?

How do you deal with counterfeit shares?

What about dramatic price movements? Should they be allowed to move as far the market wishes, or should there be daily trading limits? Explain your reasoning.

Should trading be halted until investigations can be made to determine if market manipulation or insider trading is taking place? Explain your reasoning.

**Outline your steps and explain your reasoning for the Nanda Capital Markets Administration to follow to deal with this apparent crisis.**

## Part 2

Why do you suppose Imran and other insiders apparently were able to avoid prosecution? Could that happen in Jordan today? Explain your reasoning.

How could Imran have been able to sell some of his shares, when employees were forbidden to sell shares for two years?

What kind of company do you think NF became under the management of Imran's son? Aggressive and progressive? Overloaded with middle managers and bureaucratic? Stable and arrogant? How would this affect the ability of NF to compete in the open market place?

Why do you suppose NF did not seem to be significantly affected by the capital market reforms?

When should the decision to promote Sayed to CEO have been made public? Do you think the price activity might have been caused by insiders discussing the possibility? If so, how would you attempt to prove it?

Should Sayed have released his various ideas to the public? Explain your reasoning.

Why did Sayed begin implementing his strategy with the tariff issue? What effect do you think might have occurred from his father's "effusive praise"?

Should this strategy have been released to the public? Was the strategy likely to have caused the continuing movement in the stock? Explain your reasoning.

What do you think of the Board decision to not release the news of the RFPs? Why do you feel that way? Should there be an investigation into the stock trading at this time? If yes, how would you go about the investigation?

Was it ethical for Sayed to discuss his idea for a "palatial spa" with his friend at "International Spas?" Should the agreement for International Spas the study the feasibility of the proposal have been released as public information? Or privately with the Board of Directors? Explain.

What are ADRs? Can ADRs effect the price movement of NF on the Nanda Stock Exchange? How can the NSE and/or the Nanda Capital Markets Administration investigate trading in NF ADRs on the NASDAQ market?

Is the engagement of a US based Investment Banker material information? Is the change of accountant/auditor material information? Do you believe the information should have been released to the public? If yes, and the information had not been released to the public, what should the NCMA do about it?

What is a subscription rights offering? Should trading in rights be allowed on the NSE? What does "when as and if traded" mean? Should "when as and if traded" trading be allowed on the NSE? If not, why not? How can "when as and if traded" trading be regulated? Are subscription rights and "when as and if traded" contracts derivatives? Should the additional tools that were put in place with capital market regulation reforms enable the NCMA to regulate these derivatives?

Should the NCMA have jurisdiction over curb trading now that capital market reform tools are in place? How can that be implemented? If, no, why, and how can it be stopped?

**Outline your steps and explain your reasoning for the Nanda Capital Markets Administration to follow to deal with this apparent crisis.**

# ***REGULATING EMERGING CAPITAL MARKETS***

**Text: "Securities Regulation in Emerging Markets: Issues and Suggested Answers"**
**By: Robert D. Strahoda**

- **Enforceable Contract Law**
- **Full and Fair Disclosure**

These are the two primary roles of Government in a capital market scheme. Complete discussion of each bullet.

- **Fair, orderly, honest and transparent markets**
- **Prompt and accurate clearance and settlement of securities transactions**
- **Prohibition of fraudulent conduct and transactions**
- **Dispute Resolution**

These are the primary roles of the market practitioners in a capital market scheme, with governmental oversight for compliance. Complete discussion of each bullet.

**Exercise Session:**

"Which capital market regulatory activities work well in Jordan, and which capital market regulatory activities need improvement."

Hand each attendee a list of regulatory activities, and have them individually evaluate how the activity is being performed in Jordan. Summarize the results and discuss the consensus activities and differing opinions – possibly in breakout groups. If breakout groups are used, each breakout group reports to the whole group. If breakout groups are not used, the facilitator leads a discussion about the consensus activities and differing opinions.

Exercise Instructions: Review the activity, circle Yes if you believe the activity is being preformed well in Jordan. Circle No if you believe the activity is not being performed well in Jordan. You do not have to answer an activity that you do not have an opinion about, or about which you believe is outside your experience.

| **Activity** | **Performed Well?** | |
|---|---|---|
| Matching trade orders between buying broker and selling broker | Yes | No |
| Good (properly endorsed) delivery of stock certificate by selling customer | Yes | No |
| Daily netting of transactions | Yes | No |
| Timely delivery of stock certificate by selling customer | Yes | No |
| Timely delivery of stock certificate by selling broker | Yes | No |
| Timely payment to selling customer by broker | Yes | No |
| Timely payment to broker by buying customer | Yes | No |
| Timely delivery of certificate or depository receipt to buying customer | Yes | No |
| Filing Issuer annual financial report | Yes | No |
| Accuracy of Issuer financial reports | Yes | No |
| Accuracy of brokers financial reports | Yes | No |
| Filing Issuer quarterly or other periodic financial reports | Yes | No |
| Timely reporting by Issuers of material news information | Yes | No |
| Issuer filing of significant change of ownership or controlling interest | Yes | No |
| Licensing of market intermediaries (brokers, agents, etc.) | Yes | No |
| Auditing brokers financial books and records | Yes | No |
| Market surveillance for unusual trading patterns | Yes | No |
| Investigations of apparent unusual trading patterns | Yes | No |
| Issuing sanctions to brokers for inappropriate behavior | Yes | No |
| Prosecuting insider trading violators | Yes | No |

| **Activity** | **Works Well?** | |
|---|---|---|
| Prosecuting market manipulation violators | Yes | No |
| Dematerialization of securities | Yes | No |
| Prompt matching of buy/sell orders | Yes | No |
| Prompt reporting of transactions | Yes | No |
| Customer protection from broker default | Yes | No |
| Dispute resolution between brokers | Yes | No |
| Dispute resolution between brokers and customers | Yes | No |
| Regulation of short selling | Yes | No |
| Immobilization of securities | Yes | No |
| Protection of minority shareholders rights by Issuers | Yes | No |
| Timely transfer of money between banks and brokers | Yes | No |
| Timely transfer of money between brokers, and SDC | Yes | No |
| Ability to obtain testimony (proof) from any person or organization | Yes | No |
| Regulate Banks that act as brokers | Yes | No |
| Ability of customers to sue brokers for malfeasance | Yes | No |

- **UNDERLINE THE TWO (2) ACTIVITIES YOU BELIEVE SHOULD HAVE THE HIGHEST PRIORITY TO IMPROVE**

# ***REQUIREMENTS FOR EFFECTIVE COOPERATION AMONG REGULATORS***

- **Domestic Cooperation**
- **Among Securities Market Regulators**
- **Law Enforcement Agencies**
- **Judicial Agencies**

- **International Cooperation**
- **Cross Boundary Listing**
- **Cross Boundary Trading**
- **Cross Boundary Misconduct**

**The globalization of securities markets trading has created a higher level of required cooperation between enforcement authorities. Complete discussion of each bullet.**

## Second Exercise Session:

**"How can the barriers to effective cooperation among the JSC, ASE and SDC be overcome?"**

**Facilitated flip chart exercise: 1) identify barriers to effective communication; 2) prioritize the barriers; 3) discuss the two most significant barriers, and develop recommendations about overcoming the barriers**

Workshop flip charts, **"Investigating Market Manipulation and Insider Trading"**

**Barriers to effective investigation**

- Small nation, and influential people all know each other
  - Thus, an investigation might uncover misdeeds by friends, and it would difficult to prosecute them

- Jordanians are polite and friendly, and disinclined to prosecute anyone for this kind of misdeed

- No financial reward for conducting an investigation

- No political reward for conducting an investigation

- Unwillingness to share information between regulatory agencies – JSC – ASE – SDC – Law enforcement agencies – Judiciary

- Access to other sources of information, i.e. bank records, telecommunication records, international cross-border investor records, etc. difficult to obtain

- JSC does not have subpoena power

- No apparent resolve at the Commissioner level to conduct such an investigation
  - Perhaps the political risk exceeds the political reward to lead such an investigation
  - Without this resolve, no investigation can succeed

- Political risk to professional staff is too high, to begin an investigation on their own.
  - No financial reward for taking the risk, no professional reward for taking the risk for initiating such and investigation

### Possible actions to overcome the barriers

- Very top leadership of Jordan expresses support for capital market regulation, and urges prosecution of market manipulators and inside traders
  - Jordan's leadership should recognize that it is difficult if not impossible to expand Jordan's capital market and attract investors – both local and international – without confidence in the regulatory authorities
  - Investor protection is meaningless without prosecuting market manipulators and insider traders

- Select an insider trading case that has a high probability of successful prosecution and pursue it vigorously
  - Select a cross-agency team to conduct the investigation and give them the time and resources to be successful

- Out-source the leadership of the investigation to counteract the "friendship" or "too friendly" issue
  - Out-source the leadership in the form of "mentor", providing expertise and counsel on conducting a successful investigation to the investigation team
  - Alternatively, out-source the entire investigation to a third party if the political risk is too great to the current Commission or professional staff

- Create a financial reward package that would provide sufficient reward to motivate the investigation team.

***Summary of the Investor Protection Workshop, June 24 -- 26, 2001***

June 24, 2001. Dr. Tayseer Abdel Jaber, Jordan Securities Commission, inaugurated the Investor Protection Workshop. In his remarks, Dr. Tayseer challenged the attendees to "develop a clear understanding of stock market regulation in order to insure the protection of investors".

The focus of the first day of the workshop was to discuss primary responsibilities for regulating Jordanian capital markets. Two exercises were conducted: 1) "Which capital market regulatory activities work well in Jordan, and which capital market regulatory activities need improvement?" and; 2) "What are the two most important actions the JSC should undertake to improve capital markets regulation?"

The consensus was that regulatory activities related to the operation of the market (trading, licensing, settlement and clearance) work well, but investigating/prosecuting miscreants and timely reporting of financial news do not work well.

The majority ranked implementing investigations and prosecuting miscreant for insider trading and market manipulation as the regulation activity with the greatest need for improvement – confirming the findings of the interview series conducted previously.

June 25, 2001. The focus of the second day of the workshop was on recognizing market manipulation and insider trading activities. A discussion was held on identifying barriers to initiating effective market violator investigations, and prosecuting miscreants. Some alarming conclusions were reached: the foremost conclusion being that there is little or no resolve on the part of the regulatory authorities to conduct any investigations, or to prosecute them. (See the preceding enclosure: "Workshop flip charts") The discussion continued with possible actions to overcome the barriers to initiating effective market violator investigations, and are repeated here:

**Possible actions to overcome the barriers**

- Very top leadership of Jordan expresses support for capital market regulation, and urges prosecution of market manipulators and inside traders
  - Jordan's leadership should recognize that it is difficult if not impossible to expand Jordan's capital market and attract investors – both local and international – without confidence in the regulatory authorities

- Investor protection is meaningless without prosecuting market manipulators and insider traders

- Select an insider trading case that has a high probability of successful prosecution and pursue it vigorously

- Select a cross-agency team to conduct the investigation and give them the time and resources to be successful

- Out-source the leadership of the investigation to counteract the "friendship" or "too friendly" issue

- Out-source the leadership in the form of "mentor", providing expertise and counsel on conducting a successful investigation to the investigation team
  - Alternatively, out-source the entire investigation to a third party if the political risk is too great to the current Commission or professional staff

- Create a financial reward package that would provide sufficient reward to motivate the investigation team

**These are suggestions which could serve as the basis to initiate an effective investigation.**

However, the participants in the workshop have little hope that the senior regulatory authorities have the resolve to follow-up on an investigation. One anecdote illustrates the point: An investigation revealed a probable case of "parking", a form of market manipulation which is relatively easy to prove, because trading and ownership of securities is done in the name of others, and records are relatively easy to examine proving the practice. Nothing came of the investigation because "no one could see there was any misdoing." If this anecdote was accurately portrayed to me, then it is easy to see why the workshop participants believe that senior regulatory authorities lack the resolve to prosecute offenders.

June 25, 2001. The last day of the workshop concentrated on the case study "Nature's Finest", focusing on identifying possible market manipulations, and suggested follow-up actions. The emphasis was: all actions on the behalf of principals of the company should be scrutinized, and all suspicious or extreme market movements should be scrutinized, but that not all insider actions and/or market movements constitute fraud, market manipulation or insider trading. Each instance should be investigated independently.

**CONCLUSION:** The time has come for an effective investigation and prosecution of a capital market trading offender. The JSC should select a case with a high probability of success, and concentrate the resources to pursue the case to conclusion.

It appears that it would be advisable for the JSC to engage an experienced third party professional market regulator to mentor the investigation team. A mentor would bring invaluable experience to the investigation, and would provide motivation and decisions "free of political influence" – a key to insider trading investigations.

With or without engaging a mentor, the successful prosecution of a miscreant is the strongest statement possible that the regulatory authorities are ready to enforce the laws, rules and regulations of the capital markets in Jordan. Until a successful prosecution happens, the regulatory climate of Jordan will be considered more "form over substance", a quote I heard many times during my interviews, and while conducting the workshop.

"Protecting investors" is the stated objective of the regulatory authorities I have met, and also those who attended the workshop. **Investors will not believe the regulatory authorities are protecting them, if there are no successful prosecutions of market manipulators and inside traders.**

I believe there are adequate systems and data collection in place to begin successful investigations of offenders. The most serious deficiency I see in conducting a successful investigation appears to be that the JSC does not have the equivalent of "subpoena" power – the right to force persons or organizations to disclose information pertinent to the investigation against their will. (Bank records and telephone calling records for example.) Full cooperation from the Judiciary is required, but presumably is at hand. This should not deter beginning an investigation. Now is the time. Identify an investigation with a high probability of success, form the investigating team, and begin!

**James F. Peck**
**June 30, 2001**

***Fact finding trip to Amman, Jordan, May 10 – 23, 2001***

**Objective:** Determine the current state of capital market trading regulation in the Hashemite Kingdom of Jordan. Identify key issues that need to be addressed to further improve the stock market regulatory process, and develop a training program to address the key issues, to be conducted during a subsequent trip to Amman.

**Procedure:** James Peck conducted interviews with executives from the Jordan Securities Commission (JSC), the Amman Stock Exchange (ASE), the Securities Depository Corporation (SDC), Brokers, Asset Managers, and Custodians. A list of the interviewees is attached as exhibit A of this report. The interviews normally were approximately one hour in length, and covered a wide range of topics related to capital market operations and regulation of the industry.

**Observations:** Mr. Peck was welcomed graciously by all of the interviewees. He found the interviewees willing and eager to discuss the status of stock market regulation, with no apparent attempt to conceal information from him.

From the very first interview, it became apparent that virtually all interviewees felt that the legal infrastructure, and adequate automated market operations hardware/software were in place to operate a modern securities trading market. Having said that, there was a divergence of opinion about the use of the tools available to the regulatory authorities for assuring full disclosure and market trading transparency – and punishing offenders. Market practitioners (brokers, asset managers, custodians, etc.) felt strongly that there was a strong tendency to have all of the "right" laws, rules, regulations, and systems, but that the implementation of the regulatory process was lacking. "Form over Substance" was the quote from one interviewee. Market regulators (JSC, ASE, and SDC) tended to feel the presence of the "right" laws, rules, regulations and systems proved they were fulfilling their missions.

Several common themes for improving market regulation developed as key issues during the interviews: 1) inadequate corporate governance; 2) lack of full disclosure; 3) lack of timely reporting of material information; 4) unfettered insider trading; 5) uncertainty about separation of regulatory roles and responsibilities among the JSC, ASE and SDC; 6) reluctance to make data of one agency available to the other agencies; 7) few, if any, sanctions or penalties being assessed against miscreants.

**Conclusions:** Significant infrastructure for the regulation of stock market operations already is in place. The progress in automating the ASE and SDC seem to be proceeding at a very acceptable pace. The SDC in particular appears to be well ahead of most emerging capital markets in establishing a depository, and facilitating settlement and clearance.

However, virtually every interview revealed that efforts to find and prosecute persons engaged in illegal and/or unethical market trading practices was inadequate. Virtually every interview identified "full disclosure and timely release of financial information"

and "insider trading" to be the two most critical regulatory needs. A workshop on corporate governance already is scheduled, which should address full disclosure and timely release of financial information, therefore, it appears that this workshop addressing stock market regulation should emphasize insider trading.

Finding and prosecuting insider trading and market manipulation are two of the most critical functions of a capital market regulatory regime. Emerging markets will make little, if any, progress toward protecting investors, or attracting investor capital without complete transparency in market operations. The existing automated systems are available to provide most of the information and data to prove insider trading and market manipulation cases. **What now is required is the resolve on the part of the regulatory agencies to pursue offenders.** The regulatory workshop will be designed to develop an understanding of market manipulation and insider trading -- how to recognize it, and how to prosecute it.

**James F. Peck**
**31 May 2001**